DR. KURT RICHEBÄCHER

English Correspondents:
Hahn Capital Partners Inc.
CANADA

Frankfurt
GERMANY

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"It remains true that irrational fancy and downright foolish hopes or fears count for much in the short run. But it is no less true that they never provide the motive power of a boom and that they never prevent the real state of things from asserting itself eventually."

Business Cycles, J. P. Schumpeter, p. 683
McGraw-Hill Book Company, New York, 1939

HIGHLIGHTS

Without a doubt, the two main issues destined to shape the financial landscape for most of the 1990s are whether a U.S. economic landing will be hard or soft, and the ultimate outcome of German unification.

The rebuilding of East Germany and Eastern Europe could produce a redirection of global capital flows in the 1990s as great as those produced by the OPEC oil shocks in the 1970s or by Reaganomics in the 1980s.

This tide change in capital flows will set in motion a major long-term appreciation of the D-mark, particularly against the U.S. dollar and related currencies.

From a structural viewpoint, a long-term growth potential of 4% for the German economy seems very feasible and could, in fact, be a rather conservative estimate. Never before has the economic and financial situation in Germany compared so favourably with that of the United States as it does presently.

The gross difference in the expected longer-term growth performance of Germany and the United States must favourably impact the D-mark exchange rate against the dollar. That trend can be expected to last for most of the decade.

For the very first time in many years, we have a situation in which the dollar has to stand against the D-mark and a booming German economy without any comparative interest rate support. And that situation now occurs at the time of a cyclical weakening in the U.S. economy.

The salient point is that international capital flows have already reacted to the changing international environment. In short, German unification will engender a massive reallocation of global capital in the 1990s away from the big borrowers of the 1980s towards the rebuilding of East Germany.

The outlook for the D-mark is bullish. The simple logic of it all is so compelling and yet so unpopular. Most persuasive of all is the reasoning that if Germany's Bundesbank is to successfully contain inflation, it must commandeer a strong currency in order to smoothly facilitate the massive reallocation of German resources and capital flows so necessary to the rebuilding of East Germany.

D-MARK/DOLLAR: ON A COLLISION COURSE

Our attention remains sharply focused on the two key issues that - already this early in the 1990s - promise to be the centre pivot points of the emerging financial landscape of the decade: a soft or hard landing for the U.S. economy, and the outcome of the German unification. These two questions will prove to be the critical hinge off of which will swing the fortunes of world currencies and financial markets. They are as critical to the direction of world capital flows as continental divides are to water flows.

Before we re-examine these two issues, let's briefly review the logic and experience of the five crucial factors which determine longer-term (not necessarily short-term) exchange rate trends:

1) relative inflation rates;
2) trade balances;
3) relative economic growth rates;
4) interest rate differentials; and,
5) business profits and investment.

U.S. inflation as measured by the consumer price index (CPI) is presently 4.7%, which is above the level of a year ago. During the 1980s, the United States recorded a cumulative rise in consumer prices of 56%. The cumulative rate for the prior decade amounted to 71%. Germany's inflation experience, on the other hand, is as follows: 2.3% currently, and a cumulative rise of 25% in the 1980s versus a 61% rise in the 1970s.

Looking at U.S. inflation from this global perspective, we can't find any grounds for the braggadocio and complacency that breeds the view that an annual U.S. inflation rate of close to 5% is a tremendous achievement. Moreover, it seems obvious to us - in contrast to most other economists - that this 5% rate grossly understates the real underlying inflationary pressures in the United States.

U.S. inflation in the 1980s has been grossly understated by the CPI simply because an exploding trade deficit diverted a considerable part of excess domestic demand away from domestic output, thus spilling out abroad. That diversion kept domestic price inflation at bay. Inflation, so to say, was exported. The large cumulative current account deficit amounting to about $800 billion during the 1980s is a telling measure of the extent to which U.S. inflation was shifted abroad.

Just think of it. $800 billion of demand equates to roughly 15% of present GNP. If this huge volume of demand would have fallen on domestic U.S. output instead, rather than leaking out into imports, clearly, double digit inflation would have cut the U.S. recovery short many years ago. Soaring inflation would have led to sky-high interest rates and a credit crunch, just as happened in the 1970s and the early 1980s. It was, in other words, nothing more than the trade gap that made the long "inflationless" boom of the 1980s possible.

Accounting for the internal price and trade effects together, it becomes apparent - contrary to perception - that this economic expansion in the United States was more inflationary than the upswing in the 1970s. As we already said, the main reason why the price indexes have not exploded is that an exceptionally large part of the excess demand was diverted into imports.

In the 1970s, however, this release valve did not function because the rest of world inflated in lock-step. The United States only showed a cumulative U.S. current account deficit of a mere $4.4 billion for the whole decade. As a result, excess money vented completely into the domestic price indexes.

In fact, the credit numbers bear out our viewpoint. During the 1970s, overall U.S. indebtedness grew by $2,266 billion ($2.27 trillion) or 169.2% and in the 1980s by $6,219 billion ($6.22 trillion) or 174.5%. One must also take note of the absolute amounts of debt, especially in relation to the size of GNP. And, one shouldn't forget that the private savings rate also collapsed in the 1980s.

THE ESSENCE OF INFLATION

As a reminder, we should quickly review what the true definition of inflation really is. It's essence, of course, is not the widely-observed phenomenon of rises in general price levels. Rising prices are simply one of several symptoms that imply the underlying cause of inflation. Inflation is an overexpansion of credit relative to savings. When that condition occurs three main effects are usually observed: first, economic distortions; second, speculative excesses; and third, over-indebtedness.

The most obvious and damaging economic distortions of past credit excesses can readily be seen today in the United States and several other countries. All of them are afflicted with various degrees of over-consumption, under-savings, a persistent type of profit squeeze, under-investment, over-indebtedness, over-valued assets and, of course, mammoth trade deficits.

Today, unprecedented imbalances and distortions have accrued from unprecedented credit inflation. However, the massive diversion of this inflation into a deteriorating trade deficit and pumped-up financial markets has created an alluring mirage of stability and financial wealth that breed complacency and quenches all sensible alarm. The tragedy is this: the same exploding trade deficit that has been crucial in avoiding a credit crunch and extending longevity to the economic upswing over the shorter-term (by suppressing prices and camouflaging inflation) in the end will have abetted the most rampant monetary inflation that the United States has ever experienced . . . except perhaps since the 1920s.

COMPLACENCY, COMPLAISANCE AND COMPLIANT THEORIES

American and English economists are great in inventing ever new complaisant theories that transform every problem into a non-problem. The more durable the trend and the bigger the excess, the more pleasing and authoritative the theory. In Orwell's *Oceana*, the Ministry of Truth has the task to strip words of their undesirable meaning . . . ie. ignorance is strength, slavery is freedom. True to the principles of Orwellian "newspeak", today's economists have successfully put new "truth" into economic thinking. Now deficit is dynamism and surplus is torpidness.

At the same time, it has become a dogma that any deficit - whether budget or trade, and no matter how big its absolute amount - becomes irrelevant for the markets and is indefinitely sustainable as long as the deficit stops increasing relative to GNP.

Currency and financial markets, to be sure, have proven to be quite insensitive to trade and current account deficits in recent years. The most perverse and brazen effect of this new attitude which has been observed over the last three years is that currencies have systematically moved in diametric contrast to underlying fundamentals (as defined by inflation and trade balances).

The key reason is that confidence in existing exchange rates has transformed the currencies with high nominal interest rates (those countries with high inflations and large deficits) into powerful magnets for international capital and liquidity. Capital inflows which exceed current deficits in turn provoke

currency appreciation. A rising currency tends to mask the severity of domestic inflation, caps rises in interest rates, promotes accommodating monetary conditions and simultaneously worsens the underlying current account.

Demonstrable proof of the effect of these capital flows can be seen in the three deficit nations of Europe: Spain, Britain and Italy. During the last two years these countries have sextupled their combined current account deficit from $9 billion to $56 billion, yet they harbour the strongest currencies.

In Europe, DM-pegging has become a soft option for inflation countries to suppress and camouflage inflation through a strong domestic currency. For example, Britain is now exploiting this technique in a really shameless way. As we've mentioned before in a much earlier letter, this technique of exporting off inflation has become the new version of the "beggar-thy-neighbour" policies of the 1930s. Then, the motive for currency rigging was to export unemployment. Today, the motive is to export price inflation.

THE GERMAN LOCOMOTIVE

It is clear, therefore, that the softness of the D-mark in the European Monetary System (EMS) has nothing to do with inferior economic prospects, but is solely the outcome of the current exchange rate regime. Yet in the jargon of the market, perception has it that the D-mark is "weak".

Precisely the opposite is true. After years of relatively feeble growth, the West German economy has "bulleted" into the position of being the G7's locomotive, even to the extent that its growth may well outperform that of Japan. Now, for Germany, the massive economic impact of unification comes on top of an economy already cruising at Autobahn speeds; close to full capacity limits. Unification and the continuing immigration from Eastern Europe make it highly possible that the German economy will maintain maximum growth potential right into the next century.

GERMANY: SOURCES OF GNP GROWTH
(% at annual rates)

	1986	1987	1988	1989
Productivity	1.8	2.1	3.7	3.4
Employment	1.4	0.7	0.7	1.4
Man-hours Worked	0.5	-0.4	0.0	-0.6

Source: Bundesbank, Annual Report, 1989, page 14

In this respect, the adjacent table is instructive. What we want to point out is that Germany's economic growth of the past has been largely confined to the parameter of productivity growth (which averaged about 2.5% annually) and little else. Employment also grew in recent years, but was offset by a general shortening of the work week. However, trade unions have agreed with employers to defer further shortening of the work week to 1995. Therefore, a sharp acceleration in employment growth -currently at 2% - can now fully impact GNP growth, whereas before, employment growth played an insignificant role. From this perspective, a long-term growth potential for the German economy rate of 4% seems very feasible and could, in fact, be a rather conservative estimate.

On the other side of Atlantic, though, it is equally certain that U.S. growth potential is markedly lower. America's main source of economic growth in past years - namely labour force and employment growth - has fallen to about 1% annually from a range of 2-3% in the 1970s and 1980s. At the same time, potential productivity growth is being held down by record-low industrial net investment. Productivity growth barely averaged 1% per annum during the 1980s. A potential longer-term U.S. growth rate of no more than 2-2.5% at best now pales to that of 4% for Germany.

One shouldn't forget that we are speaking here of structural issues that set the long-term parameters for these two economies; not cyclical and short-term factors.

In fact, a unified Germany, supplemented with the over-proportionately large productivity gains that can be expected in the part represented by the former East Germany, might well achieve 5% growth annually in the long run compared to a long period of near-stagflation in the United States.

CAPITAL FLOWS: THE CRUCIAL INFLUENCE

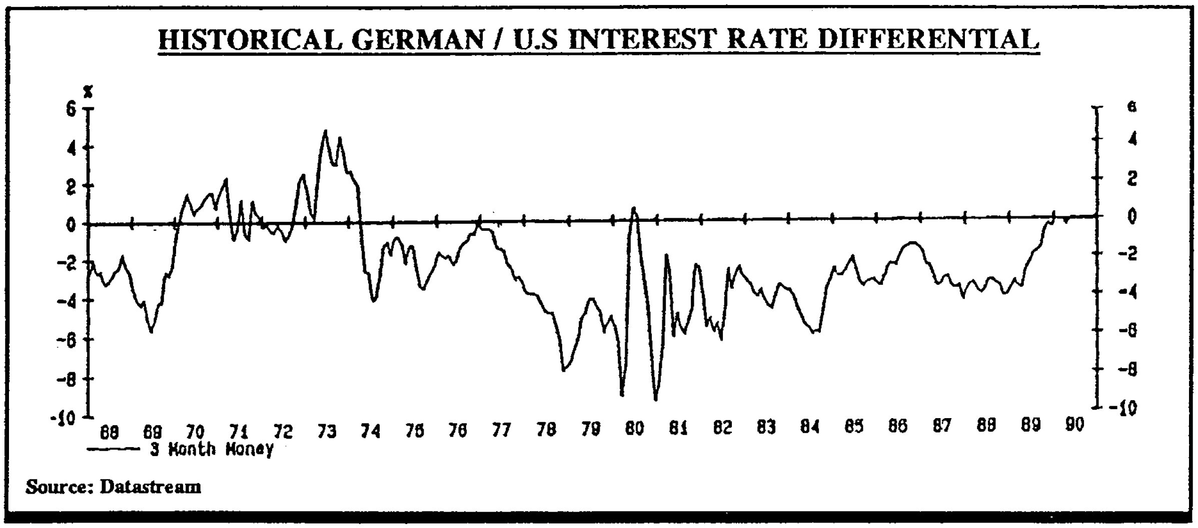
As we have often explained, the surest influence on the DM/dollar exchange rate during the whole post-war period has been the cyclical mismatch between the two countries.

The principal mechanism behind this phenomenon depends on the relative monetary conditions and their reciprocal impact on the two capital accounts. When a booming U.S. economy was subject to a restrictive monetary policy, surging capital inflows have usually over-financed a widening trade deficit thus begetting a soaring dollar. Conversely, when the German economy boomed, capital flows tended to reverse towards Germany therefore driving the D-mark up. What's more is that this mechanism has functioned this way fairly rigorously even though German interest rates were considerably lower than U.S. interest rates generally, In fact, that's been the rule for almost 20 years.

All of that leads to a very important observation. For the very first time in many years, we now have a situation in which the dollar has to stand up against the D-mark and a booming German economy without any interest rate support. The chart on the next page shows a historical perspective on the present narrowness of the interest rate differential between Germany and the U.S..

Last but not least, we ought to stress another point that is crucially important to the longer run in our view, but which tends to find little interest among Anglo-Saxon economists. Germany's current expansion is driven by profits and investment. Corporate Germany has entered the 1990s with booming profits and exceptionally strong balance sheets. America, by contrast, has had a debt-driven profitless consumption boom marked by record-low investment. High interest rates, therefore, do not threaten with serious financial risk nor a calamitous slowdown as far as Corporate Germany is concerned.

Comparison Shopping. Compare item for item the major differences in the investment features of the currencies of these two major economies. The differences are striking in inflation, economic growth rates, in the trade balance, and in business profits and investment. Peculiarly, the only thing that is the same is interest rates and, moreover, are at a differential at the narrowest extreme. We would say that never before has the economic and financial situation in Germany compared so favourably with that of the United States as it does presently.



PERCEPTION VERSUS OBJECTIVE FACTS

Despite the facts, markets wish to transcend the strings of objectivity. On July 2, the European edition of the Wall Street Journal ran a big headline: "*Dollar is Expected to Climb Against Mark*". It introduced an article about a survey of economists and traders in London, Frankfurt, New York and Tokyo. Actually, the result did not surprise us. Nor were we surprised to read that the most bullish forecasts for the U.S. dollar against the D-mark came from two Germans.

Over time, we have learned (see the Schumpeter quotation on the first page) to distinguish between market perception - namely market psychology and market sentiment - and the hard objective facts of a situation. Occasionally, they differ both diametrically and dramatically. That's not unusual but one shouldn't forget that the changing fundamentals of a situation are the certain prelude to a change in perceptions.

THRIFT CRISIS VERSUS UNIFICATION

On the same page of the currency survey we just mentioned, with a similarly big headline, the Wall Street Journal reported on the Resolution Funding Corporation's (Refcorp, which is the funding agency that has been formed to liquidate the assets of the many failed Savings and Loans) sale of 155 failed Savings and Loans estimated to cost $45 billion. All of that has to be borrowed, of course. The inventory of unsold real estate alone is $400 billion and growing. At the same time, budget deficits are surging at all levels - Federal, state and local - because the weakening economy is boosting expenditures and hammering tax receipts.

Expected borrowing requirements have vaulted the general federal budget deficit, too. As recently as January, the Administration had forecast this year's deficit (minus Refcorp requirements) at a mere $61 billion. Now, the number that is being bandied about is $159 billion (again minus Refcorp). Add to this the expected Refcorp borrowing of $50-60 billion and it sums up to an increase in federal borrowing requirements that alone far exceeds the forecast costs of German unification.

All these facts are well-known to the markets. After all, we've quoted these figures from prominent articles heralded by bold headlines. Yet, all of it is shrugged off as irrelevant. Despite the new

public borrowing binge, U.S. government bond yields have declined from 9.1% to 8.4% in recent months while German yields shot up from 7.5% to the present 8.6%. German rates had temporarily hit 8.9% earlier in the year. Yet, Germany has 2.3% inflation and an annual domestic savings surplus of 4.6% while the United States has 4.7% inflation and a current savings deficit of 2% of GNP. It's hard to make sense of all this. Again: perceptions are lagging objective facts.

THE NEAR-TERM QUESTION: U.S. RECESSION

On the issue of U.S. economic prospects, we again see a striking contrast between perception and reality. News about the U.S. economy is distinctly going from bad to worse. But instead of being spooked about a possible recession, the markets are cheered by the incipient prospect of lower interest rates. The tacit assumption behind this resilient optimism, apparently, is that the U.S. economy will immediately respond to the upside once the Fed begins to ease.

It amuses us when we read again and again that the "statistics of the past few months have been extremely confusing". The confusion is exclusively in the analysts' heads and not in the data.

The most significant sign, at long last, is that the consumer is cracking. It was the key argument of the "no-recession" school that the service sector and the consumer would propel the U.S. economy forever.

What used to be the biggest reason for complacency is fast becoming the biggest reason for concern. Sharply slower growth in jobs - now witnessed both in manufacturing as well as services - is hitting incomes. During the first five months of the year, the consumer's real disposable income (earnings adjusted for inflation and taxes) has fallen off a cliff to an annual rate of only 1% compared with a rate of 3.8% for all of 1989. Consumer confidence has plunged to the lowest level since November 1987 - that being immediately after the bone-chilling stock market crash. Though this drastic downturn in income growth virtually pulverizes the argument that consumer spending will keep economic growth on track, forecasts remain unchanged.

And what about the rest of the economy? Businesses confronted with stagnating or weakening demand and a profit squeeze are definitely scaling back their capital spending. Construction is in an outright slump.

The only GNP component that is still growing is exports . . . but at a much slower pace than over the past three years. Everybody knows of the fragility and the vulnerability of the financial system. Yet the markets seem to be getting more and more upbeat.

JULY 27TH: A CRITICAL DATE

We would say the signs of a weakening economy are converging and are becoming all the more undeniable. Not only that, but as already indicated in the last letter, the figures are also riddled with inconsistencies and incongruities. Drastic downward revisions are multiplying. In April, the government revised its figure on growth of industrial production from a gain of 0.5% to a decline of 0.4% for the second half of last year. Nevertheless, the restatement did not appear in any of its public publications. A little later, the U.S. Department of Commerce sneaked out a report that personal income had been overstated by a whopping $50-60 billion in the first three quarters of 1989 alone. In the final count, this reduction would drastically reduce personal savings and GNP growth

back through to the start of last year.

But any such downward revision, though already partly foreshadowed officially, are not yet incorporated in the statistics. This will happen in one big sweep with the bench mark revisions scheduled to be published on July 27th. That day could therefore prove to be critically important for the markets.

MARKET PERCEPTION: WHO IS THE MARKET?

Never before have we seen such a stark chasm between the testimony of market euphoria and the miserable facts of the economy and financial markets as presently in the United States. Therefore, we keep asking ourselves who it is that actually determines and expresses market sentiment? Looking at the media one only sees professional market players quoted there. Sentiment is formed in the interplay between traders, institutional investors, analysts and the media, all of which may have little or nothing to do with sentiment of the individual investor. There seems to be a strong dichotomy between these two groups of investors, not only in the U.S, but also elsewhere.

A striking example of this phenomenon was the deep gloom about the German bond market in the past months. Who was so morose on fixed income prospects? It was all the professionals, and by the way, German professionals were no better than those of Wall Street or in the city of London.

Now compare this professional gloom with the behaviour of the German individual investor. The private investor virtually stampeded into German bonds as never before. Despite the best advice of the so-called professionals, the individual obviously thought that the high yields were a bargain. To appreciate the dramatic surge of the private bond-buyer, one has to see it in relation to levels of past years. (See Table 2 on the this page).

There was a brief panic selling of German bonds by foreigners in February/March. But by April, the non-resident investor returned again with small net buying, which, according to preliminary figures increased to DM 3.5 billion in May. Going the other way, former huge German purchases of high-yielding foreign currency bonds have diminished to a trickle.

GERMANY: NET PURCHASES OF DOMESTIC BONDS
(in Billions of D-mark)

	Banks	Non-Banks	Non-Residents
1987	42.2	11.0	35.0
1988	30.2	2.9	2.0
1989	8.8	47.2	22.4
1990 January	5.0	17.2	0.3
February	5.6	13.0	- 6.3
March	3.2	12.4	- 5.3
April	-4.4	9.8	1.1
Jan. to April 1990	9.4	52.4	-10.2
Jan. to April 1989	2.8	15.9	-4.2

We observe the exact opposite in the United States. The professional view is that foreign investors should rush into long-term bonds in order to rake in capital gains from falling yields. While it seems plausible, it's sheer fantasy. According to official data, foreign investors (excluding central banks) only bought a mere $700 million net of U.S. stocks and bonds in the first three months of the year.

That compares dismally with the 1989 average quarterly take-down of $18 billion. Net central bank sales of $5 billion pushed the total into negative territory.

What, then, has been holding up the dollar given this drastic reversal in capital flows? The only possible explanation is this: the hot money flows and short-term speculation driven professionals dollar bulls.

The salient point is that international capital flows have already distinctly reacted to the changing international environment. But it doesn't fit into the professionals' preconceived opinion. Inertia is a fact of life in the markets.

To be quite frank, Wall Street's euphoria is not as puzzling as it seems. It's purely professional egg-whisking. The individual investor has long deserted the U.S. stock market. What we continue to see is the familiar speculative froth. And the same holds true for the dollar, only here it is the simple trader activity generated by chart patterns. In that regard, it strikes us that the dollar generally recovers in Europe and weakens in the U.S.. European traders are the most stubborn dollar bulls.

THE TWO DIFFERENT KINDS OF PROFESSIONALS

Having made our comments about professional investors, we want to draw attention to the fact that there are two different kinds of professionals: those that are market oriented (the ones with all the publicity), and scientifically oriented economists (with little or no publicity). Lots of reports have been published about German economic and monetary unification (Gemu) and its implications, both positive and negative. Only the negative ones, however, got all the media and market publicity.

The other day, we spoke in Venice to an audience of about 400 traders and other financial professionals. German unification was, of course, one topic. We read to them the following sentence: "*In all the simulations, economic union leads to an acceleration of growth and investment in Germany, a real appreciation of the Deutschemark and a reduction in Germany's current account surplus.*" Explaining that this sentence was from the first page of a rather lengthy study about the global economic implications of German unification by a very important institution that was published in April, we asked who had heard of it. Not one had. Actually, the report was prepared by the staff of the Board of Governors of the U.S. Federal Reserve System.

Based on varied assumptions, the study of the Fed staff made detailed quantitative estimates for inflation, GNP components, interest rates, current account and the DM/$ exchange rate. Altogether, the study presents six different simulations, all of which except one have five features in common. These five factors were as follows: stronger GNP growth, an investment boom, an appreciating D-mark, a modest rise in inflation and a declining current account surplus.

The one simulation which was the exception forecast much higher inflation initially. In that scenario, the DM is assumed to be pegged against the dollar. Needless to say, that is the one assumption that won't see reality.

The inset on the next page and the table on page 11 shows extracts of the chief projections of the principal scenario of the FRB report. All figures are expressed as a deviation from a baseline scenario assuming no unification takes place.

MAIN SUMMARY OF FEDERAL RESERVE BOARD REPORT*

The following list briefly summarizes the conclusions of the FRB based on the main scenario of six simulations.

* Key to the overall impact of German unification on the economy and markets is the interaction between stronger growth and investment, higher interest rates, capital flows, and a rising currency.

* Inflation will increase modestly in the first years; thereafter, it will fall back.

* Both short and long-term interest rates will be up to 80 basis points higher than the baseline scenario in the years ahead.

* In real terms, roughly half of the increased demand for fixed investment and government purchases is met by reduced net exports. The remaining half is met by higher output and lower consumption.

* The appreciation of the DM implies that a much smaller fraction of the increased demand is met by reduced exports in nominal terms. But the German current account improves in the first year due to the J-curve.

* Taken from Board of Governors of the Federal Reserve report entitled "The Economic Implications of German Unification", April 16, 1990.

Another Optimistic Study. In the meantime, the OECD (Organization for Economic Cooperation and Development) has also published the findings of a study on German unification in its new report on Germany. The conclusions here are also very optimistic. We include two further statements from this last report that complement those of the Fed staff in the inset as follows:

o The financing of a sizable real transfer of resources to the GDR poses no problem if only part of the Federal Republic's excess saving over investment as reflected in the huge current-account surplus could be smoothly redirected to this end.

o In conjunction with a policy-mix of tighter monetary conditions and a temporarily more expansionary fiscal stance, there could be upward pressure on the real exchange rate, as capital flows are induced and capital outflows to countries other than the GDR become relatively unattractive.

We dare say that both the analytical approaches and the conclusions of the Federal Reserve Board and the OECD (and also the International Monetary Fund) concur closely with our own conclusions as expounded above and in recent letters.

Essentially, our argument has been that the booming German economy and exploding public and private capital requirements for the rebuilding of East Germany combined with high rates of return and interest will result in a "capital implosion" - meaning slumping capital outflows and heightened capital inflows - even at current interest rates levels. That will strengthen the D-mark. The line of causation will be from capital flows . . . to currency adjustment . . . to declining current account.

CONCLUSIONS

In short, German unification will engender a massive reallocation of global capital in the 1990s away from the big borrowers of the 1980s towards the rebuilding of East Germany.

SIMULATION OF GERMAN UNIFICATION
Deviation from Base Line for United Germany

	1990	91	92	93	94	95	96	97	98	99
Real GDP	0.7	1.4	2.1	2.8	3.3	3.8	4.3	4.8	5.1	5.5
Fixed Inv. (% of GDP)	1.0	2.3	3.1	3.5	3.7	3.8	3.7	3.6	3.5	3.3
Priv. Cons. (% of GDP)	-0.2	-0.0	0.1	0.4	0.6	0.9	1.2	1.4	1.7	1.9
Gov't Exp. (% of GDP)	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7	1.7
Real Net Exp. (% of GDP)	-1.3	-2.0	-2.3	-2.3	-2.3	-2.1	-1.9	-1.6	-1.4	-1.1
Inflation(%)	0.3	0.2	0.1	0.0	-0.0	-0.0	-0.1	-0.1	-0.1	-0.1
S.T.Int.Rate	0.4	0.6	0.7	0.8	0.8	0.7	0.7	0.6	0.5	0.4
L.T.Int.Rate	0.6	0.6	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.2
Nom. Exch. Rate (% $/DM)	7.8	7.5	7.2	6.6	5.9	5.2	4.5	3.8	3.2	2.6

Source: Board of Governors of the Federal Reserve.

This tide change in capital flows will set in motion a major long-term appreciation of the D-mark, particularly against the U.S. dollar and related currencies.

The pull of the D-mark - due to internal German boom conditions - will be reinforced by the contrasting deteriorating conditions in most of the deficit countries.

In some of these countries - above all the United States - a major recession is getting under way as weak investment and a plunge in consumer incomes take their toll.

In the upcoming policy conflict between a U.S. recession and dollar stability, the Fed will have no choice but to try to support the economy through easier money. As such, the dollar is bound to suffer.

The gross difference in the expected longer-term growth performance of Germany and the United States must impact the dollar/D-mark exchange rate, and can be expected to last for most of the decade. As we repeatedly have stressed, it's not just merely a cyclical phenomenon but one with largely structural dimensions.

At the end, Schumpeter's comment again has relevance. "*Irrational fancy and downright foolish hopes or fears never prevent the real state of things from asserting itself . . .*".

The real state of affairs is that the German economy in unison with most of Continental Europe has

entered an "era" of new dynamism while the U.S. economy and its financial system are drifting into unprecedented economic peril. So far, the U.S. decline has been grudgingly slow, having started back in early 1989. But, now, the critical stage of near-recession is at the doorstep.

The simple logic of it all is so compelling yet so unpopular. Most persuasive of all is the reasoning that if Germany's Bundesbank is to successfully contain inflation, it must commandeer a strong currency in order to smoothly facilitate the massive reallocation of German resources and capital flows so necessary to the rebuilding of East Germany.

Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer
Mendelssohn Strasse 51, D-6000 Frankfurt 1, GERMANY. TELEPHONE: 49-69-746908 FAX: 49-69-752583
Editors: Hahn Capital Partners Inc., International and Domestic Portfolio Managers
1175 North Service Rd, Oakville, Ontario, CANADA, L6W 2W1. TELEPHONE: 416-847-0010 FAX: 416-847-7742
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